

Valuing the 'Inside Basis' Shareholder Tax Liability

By Laura Markee, CFA, ASA, with significant contributions from Paul Heidt

Business appraisers who work in estate planning or other situations where a low value conclusion is beneficial to their clients know to be on the lookout for a built-in gain (BIG) tax liability. But another, less well-known shareholder-level tax liability can reduce the tax bill even further.

When a C corporation owns appreciated assets, it is common to reduce value by the amount of a BIG tax liability¹ that reflects the amount of the gain on the sale of the assets multiplied by the corporation's income tax rate. In general, the business valuation community and the courts² are accepting of the application of a BIG tax liability. A company that made an S corporation election less than 10 years before the valuation

date³ may also in some cases be able to recognize the BIG tax liability in arriving at a value conclusion.

In my experience, another liability, a shareholder-level tax on appreciated real estate inside an S corporation, will cause a hypothetical buyer to pay less for the S corporation shares than if it could buy the real estate outright. This tax liability on S corporation inside basis has received little attention in business valuation training and application.

Below is a case example of an actual valuation assignment where the shareholder-level tax was incorporated into the fair market value conclusion and ultimately accepted in full by the Internal Revenue Service (IRS).

Case background. Several years ago, our firm had the opportunity to prepare an appraisal for estate tax reporting purposes. ABC Company (not the real name) was a real estate holding company with \$3.2 million in assets, consisting of \$400,000 in cash, \$200,000 in notes receivable, and \$2.6 million in real estate. ABC's largest real estate parcel was a four-acre drive-up theater with a market value of approximately

1 Internal Revenue Code Section 1374 imposes a corporate-level tax on S corporations' income or gain recognition to the extent of unrealized appreciation that existed in the corporation's assets as of the date it switched from C corporation to S corporation status.

At any given date, the potential BIG tax liability is calculated by multiplying the highest corporate tax rate by the total unrealized appreciation in the company's assets as of the date of the conversion to S corporation status that has not previously been recognized. Any asset appreciation occurring after the S corporation election is not subject to a corporate-level tax liability.

2 *Eisenberg v. Commissioner*, 155 F. 3d 50 (1998); *Litchfield v. Commissioner*, TC Memo 2009-21; No. 15882-05 (2009); *Simplot v. Commissioner*, 112 T.C., No. 13 (1999); *Dunn v. Commissioner*, CA-5, 2002-2 USTC Para. 60,446, 301 Fsd 339 (2002); *Jameson v. Commissioner*, 267 F. 3d 366 (2001)

3 Internal Revenue Code Section 1374(d)(7) stipulates a 10-year time horizon following the S corporation election. In February 2009, when the stimulus package was passed, the BIG time horizon was shortened to seven years and applied to sales that occurred in 2009 and 2010. The Small Business Act of 2010 then reduced the time horizon to five years for sales occurring in 2011. Effective Jan. 1, 2012, the BIG horizon moved back to the 10-year period and will be in effect for 2012 and subsequent years.

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\$1.5 million. ABC also had five other properties that included two residences and several small retail establishments. All properties were in a small city on the outskirts of a metropolitan area.

ABC had been in business for many years, having purchased most of the real estate in the 1950s at a very low cost basis. We were able to piece together that the cost basis on all the real estate holdings was \$344,000. We considered that there was accumulated depreciation of \$280,000, which resulted in an adjusted basis of \$64,000, and real estate appreciation of over \$2.5 million.

ABC's founder and minority shareholder passed away in November 2008. ABC had been formed as a C corporation in the 1950s but had elected S corporation status on Jan. 1, 2004. We calculated the BIG tax liability at approximately \$780,000, using federal and state corporate tax rates and adding the BIG tax liability to the balance sheet under the asset value approach.

We then expanded our analysis to capture the shareholder-level tax liability.

'Inside basis' background. In an S corporation, the "inside basis" is equal to the original investment in the company, plus profits and additional capital contributions, less losses and distributions. "Outside basis" includes the same elements, as well as any appreciation in the value of the stock reflected by the additional amount that a shareholder paid to acquire shares of stock above the inside basis. When an investor buys S corporation stock, the starting outside basis is equal to the purchase price of the stock, while the starting inside basis is carried over from the prior shareholder. If the S corporation sells any appreciated real estate, it will report a taxable gain that passes through to shareholders. The shareholders will then pay a tax on that gain. The outside basis of the S corporation stock will not come into play until the stock itself is sold.

Now consider a hypothetical buyer who wants to buy the S corporation's real estate. Would the hypothetical buyer rather buy the S corporation stock that has a low inside basis or buy the real estate directly and acquire a basis equal to the

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fair market value of the real estate? Common sense says that the buyer would rather buy the real estate directly to have a higher basis and avoid a built-in gain tax at the shareholder level. Thus, the value of S corporation shares should be discounted to reflect the value differential between buying the real estate directly and buying S corporation shares.

A partnership or LLC taxed as a partnership is able to circumvent the shareholder-level BIG tax by making a Section 754 election—a significant reason why partnerships or LLCs are the entity of choice for real estate holdings. This election allows a buyer to receive an inside basis in its ownership interest equal to the price paid to acquire that interest. The Section 754 election, or “step-up” basis, is not available to S corporation shareholders.

Application to decedent’s ownership. Based on the amount of appreciation in the real estate and considering state capital gain tax rates at

the valuation date, we determined that the shareholder-level tax for ABC was equal to \$515,000. We combined this with the BIG tax liability of \$780,000 to reduce the net asset value of ABC by approximately \$1.2 million.

IRS acceptance. We completed the appraisal in December 2009, and the IRS reviewed the appraisal in early 2011. The shareholder-level tax and the BIG tax liabilities were accepted without question.

Conclusion. Given our experience with IRS acceptance on this issue, we recommend that appraisers become familiar with the facts and circumstances that might allow the application of the shareholder-level tax liability for S corporations that hold appreciated assets.

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